VZCZCXRO3003
RR RUEHAG RUEHDF RUEHIK RUEHLZ
DE RUEHPG #0313/01 0861519
ZNR UUUUU ZZH
R 271519Z MAR 06
FM AMEMBASSY PRAGUE
TO RUEHC/SECSTATE WASHDC 7140
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 02 PRAGUE 000313

SIPDIS

SIPDIS

STATE FOR EUR/NCE, EUR/ERA, EB/IFD/OMA, E STAFF DAN MORRISON
TREASURY FOR OASIA ANNE ALIKONIS
STATE PLEASE PASS USTR LISA ERRION
COMMERCE FOR ITA/MAC/EUR MIKE ROGERS

E.O. 12958: N/A
TAGS: ECON EFIN ELAB ETRD EZ PGOV
SUBJECT: CZECH ECONOMY: A "CENTRAL EUROPEAN TIGER" ROARS

REF: A. PRAGUE 119
¶B. 05 PRAGUE 1686
¶C. 05 PRAGUE 1325

¶1. Glowing 2005 Czech economic statistics led newspapers to trumpet the Czech Republic as one of Europe's "Economic Tigers". And in the run-up to the June 2-3 general elections, every politician is taking full credit. GOCR figures put 2005 GDP growth at 6 percent, inflation stable at 2 percent, doubling of foreign direct investment (FDI) at USD 11 billion, and the first foreign trade surplus in Czech history (ref A). 2006 started off with the GOCR announcement that industrial output grew by 15.1 in January 2006. The record economic performance in 2005 is attributed to exports (automotives), FDI (export-oriented manufacturing multinationals), and domestic consumption (real estate and consumer credit boom). The only less-than stellar figure is the unemployment rate, which has been sticky at around 9 percent, although that rate is still significantly lower than all of its neighbors except Austria.

¶2. The highly-manufacturing-and-exports-dependent Czech economy remains vulnerable to business cycle swings, although a major downturn is not expected any time soon. Fiscal adjustment remains a key vulnerability as the GOCR gears up to adopt the Euro as early as 2010. 2006 economic prospects remain quite strong with GDP growth expected in the 5 to 6 percent range, although it is not likely to top the record performance of 2005. Although the Czech National Bank (CNB) has a more conservative estimate of 2005 GDP growth (4.3 percent), it is still above the Bank's 4 percent forecast. Along with neighboring Slovakia, the Czech Republic's 2005 GDP growth ties it for fourth after the surging Baltics among EU member states. According to Eurostat's preliminary estimate, the Czech Republic in 2005 reached 74 percent of the average EU GDP/capita. The Czech national economic strategy remains to reach the EU average by year 2013.

-- -------
Domestic Consumption as Important as Exports and FDI
-- -------

¶3. Econoff met with local economists to review the rosy GOCR economic statistics and challenged them to account for the strong Czech economic performance and step out of their usual role of focusing only on the weaknesses and vulnerabilities the economy. According to Pavel Kohout of PPF, the 6 percent GDP growth figure is significantly overstated due to the Czech statistical office's (CZSO) methodological biases. The CZSO applies its own deflator for each component of GDP, which tends to understate the impact of world energy prices on GDP when energy prices increase and in reverse, overstates

the impact when energy prices fall. Once this methodology is accounted for, Kohout calculates the GDP growth for 2005 was around 4.3 percent. Still, 4.3 percent growth is no laughing matter, and Kohout believes domestic consumption boosted by the local real estate boom and consumer credit boom is contributing equally significantly to GDP growth as are the more commonly credited export and FDI sectors. Banking credits to households (mostly mortgages) grew by USD 4.2 billion from 2004 to 2005, and as in the United States, this phenomenon can be explained by record low mortgage interest rates (currently 3.7 - 4.5 percent for 10 or 20 year loans), as well as baby boomers of the early 1970s who are starting to enter the consumer credit market. Czech males between 30 and 35 years of age have the lowest unemployment rate in the economy at 3 - 4 percent. Kohout calculates domestic consumption accounted for up to 2.5 percent of GDP growth in ¶2005. For 2006, Kohout predicts GDP growth in excess of 4 percent, assuming there are no drastic changes in world energy prices.

--- -----------
Manufacturing Dependence Means Business Cycle Dependence
--- -----------

¶4. Patria Finance's David Marek acknowledged that critics do not have much room in the face of such robust figures for ¶2005. He did, however, flag the "strange" structure of the economy that makes such robust growth unsustainable and highly vulnerable to the business cycle. Specifically, Marek noted the strong ratio of manufacturing, predominantly the automotive industry, in the economy. The manufacturing sector and related industries (plastics, rubber, steel) account for about 25 percent of industrial output and up to 35 percent of GDP (using the Herfindahl Index). According to

Marek, this is the most concentrated figure among the EU-25 economies. Marek noted that the pending mega-FDI project by Korean car manufacturer Hyundai would shift this concentration even higher and make the Czech Republic that much more vulnerable to the business cycle given the highly cyclical nature of consumer demand for automobiles. (Note: Hyundai and the Czech Republic have already signed a memorandum of understanding for this one billion Euro plant, which is expected to begin production in 2008.) Unlike Kohout, Marek attributes 2005 GDP growth mostly to foreign trade. And because the German economy, the Czech Republic's largest trading partner, is likely to improve in 2006, prospects for Czech GDP growth in 2006 are bright. Marek described Czech domestic demand as "sluggish" with a 3 percent growth in 2005. He attributed the relative sluggishness to the slow rise in disposable income resulting from multinational companies, the largest employers in the Czech economy, maintaining labor contracts that prevent a rapid increase in wages to maintain competitiveness. Marek also explained that while there is a strong labor movement in the Czech Republic, labor unions are a force largely in the traditional and increasingly uncompetitive industries, such as textiles, and are relatively unimportant in car manufacturing and other growth sectors.
CABANISS